The fallout from the last financial crisis and recession is far from over. More than a decade after the demise of Lehman and Bear Stearns, among others, litigation continues related to alleged deficiencies in mortgage loans securitized as part of residential mortgage-backed securities (RMBS) offerings. Our firm thus remains extremely busy with, for example, defense of mortgage loan originators and brokers sued for purported breaches of contractual indemnification provisions and representations and warranties — regarding loans sold prior to 2008.

We must also be attentive, however, to various candidates for an extremely dubious distinction: the next financial “bubble” to burst. One of them garnering significant concern is student loan asset-backed securities, or “SLABS.” Like RMBS, SLABS are securities backed by income streams generated by loans to individuals. RMBS are generated from collateralized mortgages, while SLABS are based on non-collateralized (but sometimes government-guaranteed) student loan debt. Ironically, the rise of SLABS has not only coincided with a relative decline in RMBS, but might have played a role. Indeed, many analysts have noted that the burden of student debt has helped delay home ownership (and therefore the need for residential mortgages).

Though most student loans are federally-guaranteed, about $118.7 billion are non-guaranteed private loans. Some analysts have been bullish on SLABS, viewing private lender asset-backed securities as a good investment because private loans are generally perceived to be of higher quality (at least as compared to government-
backed student loans, which focus not only on creditworthiness, but also on need). Private student loans can be packaged together to form derivatives called SLABS, which (in theory) allow investors to receive regular coupon payments on the underlying loans. These SLABS bear significant similarities to the Collateralized Debt Obligation (CDO) derivatives that were a substantial factor in the 2008 financial crisis. But SLABS may be even more dangerous, particularly when one considers that there is no house to serve as collateral.

The SLABS market continues to swell, with about $1.5 trillion in loans currently outstanding. Meanwhile, with incomes stagnating and tuitions soaring, defaults are on the rise. Among all household debt, student debt has the highest 90-plus day delinquency rate. Some projections suggest that 40% of all borrowers are expected to miss payments by 2022. Students often do not realize that private loans tend to be more expensive, and can be more stringent with respect to missed payments. Private student debt is also more difficult to discharge in bankruptcy.

For now, it remains unclear if and when the day of reckoning might come for the SLABS market. But given that virtually everyone was caught by surprise by the speed and severity of the RMBS market collapse, it would be wise to keep a close eye on the performance of SLABS going forward.

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